Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:DEN:POSTF-162846-01
VLHamilton

date: January 24, 2002

to: LMSB Examination-Team 1778
Attn: Richard L. Gullion, Acting Team Manager

from: Associate Area Counsel (LMSB)

subject: **Recommendations on Opening TEFRA Examinations and Related Matters**
Taxpayers: 1. [redacted]
EIN: [redacted]
Last Known Address: [redacted]
2. [redacted]
EIN: [redacted]
Last Known Address: [redacted]

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum responds to your request for Associate Area Counsel Advice (LMSB) regarding the following issues. The preliminary advice sent to you on December 20, 2001, has been reviewed by the National Office. Minor changes and clarifications were recommended on Issues 3, 4 and 6, which changes are incorporated herein. None of these changes affect the original legal analysis and conclusions. Please feel free to act on this advice at this time.

ISSUES

1. In connection with the determination of whether [redacted]

[redacted], Inc. (hereinafter "[redacted]") was a United States real property holding company (hereinafter "USRPHC") in [redacted] at the time of the disposition of [redacted] stock by [redacted] (hereinafter "[redacted]"), on which entities should TEFRA examinations be opened.

2. In order to provide the necessary time to make the the determination of whether [redacted] was a USRPHC in [redacted] at the time of the disposition of [redacted] stock by [redacted], which statutes of limitations need to be protected for which entities.

3. If any of the entities on which statutes of limitations need to be protected refuse to extend the statute of limitations, can the Service issue final notices of partnership administrative adjustment (hereinafter "FPAA" or "FPAAs") based on the presumption of section 897(c)(1)(A)(ii) and Treas. Reg. § 1.897-2(g)(1)(i) that [redacted] was a USRPHC at the time of [redacted]'s disposition of the [redacted] stock in [redacted].

4. If the Service can issue an FPAA based on the presumption of section 897(c)(1)(A)(ii) and Treas. Reg. § 1.897-2(g)(1)(i), to which entity(ies) should an FPAA be issued.

5. In determining whether [redacted] was a USRPHC in [redacted], should net operating loss carryovers (hereinafter "NOL's") be valued as part of the assets used or held for use in a trade or business under the formula of section 897(c)(2).

6. If the Service determines that [redacted] was a USRPHC at a particular date in [redacted], would [redacted]'s selection of another determination date that is nearer to the [redacted], disposition of the [redacted] stock by [redacted], a date where [redacted] could prove that it was not a USRPHC, nullify the Service's determination for purposes of the [redacted] stock disposition.

CONCLUSIONS

1. In connection with the determination of whether [redacted] was a USRPHC in [redacted] at the time of the disposition of [redacted] stock by [redacted], TEFRA examinations should be opened on [redacted] and [redacted] for the [redacted] year.

2. To provide the necessary time to determine whether [redacted] was a USRPHC in [redacted], the following statutes of limitations need to be protected:

Entity	Statute to Protect	Extension Form
[redacted]	1065	872-P
[redacted]	1065	872-P
	1042	872
	8804	872
	8288	872
[redacted]	1120-F	872-I
[redacted]	1120-F	872-I

The statute extensions for the Forms 8804 and 8288 and for [redacted] and [redacted] are precautionary. If necessary, the recommended extensions for [redacted] and [redacted] could be restricted to the partnership interests in [redacted] and [redacted].

3. The Service can issue FPAAs based on the presumption of section 897(c)(1)(A)(ii) and Treas. Reg. § 1.897-2(g)(1)(i).

4. If either [redacted] or [redacted] refuses to extend the statute of limitations on its Form 1065, the Service should issue FPAAs to both [redacted] and [redacted] on the presumption that [redacted] was a USRPHC.

5. No value should be given to [redacted]'s NOLs in measuring whether [redacted] was a USRPHC under section 897(c)(2).

6. A Service determination that [redacted] was a USRPHC at some point in [redacted] cannot be rendered null with respect to the disposition of the [redacted] stock on [redacted] by a showing that at a date closer to the disposition, [redacted] was not a USRPHC.

FACTS

[redacted], Inc. was closely held by [redacted] groups prior to an IPO on [redacted]. On that date, [redacted] sold [redacted] shares of common stock. [redacted], a U.S. partnership (hereinafter "[redacted]"), held the largest interest prior to the IPO, approximately [redacted] percent. [redacted] was and is owned by two U.S. partnerships: [redacted] (hereinafter "[redacted]") and [redacted] (hereinafter "[redacted]"). At the beginning of [redacted], [redacted]'s share of [redacted]'s

capital was [redacted] percent; [redacted]'s [redacted] percent. The partners in [redacted] are two [redacted] corporations, [redacted] and [redacted]. [redacted]'s partners include primarily [redacted] and other foreign entities and persons, but some interests are also held by U.S. entities.

On [redacted], [redacted] sold shares of [redacted] for a gain of $[redacted]. [redacted] allocated all this amount to [redacted], along with other long term capital gain distributions of over $[redacted]. The major amount going to [redacted] in [redacted] was a $[redacted] cash distribution. Of the $[redacted] allocation, [redacted] allocated and distributed $[redacted] to [redacted] and $[redacted] to [redacted]. [redacted] did not withhold on these distributions, nor did either [redacted] or [redacted] report any gain from this distribution on their [redacted] Forms 1120-F.

[redacted] filed a Form 1042 for [redacted], withholding [redacted] percent on a distribution of $[redacted] in flowthrough dividend income from another partnership in which [redacted] had an interest to the two foreign partners. [redacted] and [redacted] filed Forms 1120-F in connection with this withheld tax. In addition to the USRPHC issue, the examiner also plans to examine whether [redacted] properly withheld on the dividend income allocated to its foreign partners.

For [redacted], none of the parties involved have provided the Service with any substantiation that [redacted] was not a USRPHC for the relevant period of five years before [redacted] sold the [redacted] stock in [redacted]. Just prior to a [redacted] disposition of [redacted] stock by [redacted], however, [redacted] issued a notice indicating that [redacted] had determined that it was not a USRPHC and was not one at any time during the period in which [redacted] owned stock issued by [redacted].

Currently, an IRS in-house engineer is evaluating whether [redacted] was a USRPHC during for the [redacted] year. Preliminary indications are that [redacted] was a USRPHC. If this is so, then [redacted] would have withholding obligations on the distribution of the $[redacted] to its [redacted] partners. (See Area Counsel Advice issued on December 7, 2000, attached hereto, and hereinafter referred to as "2000 Advice".) In order for the engineer to have sufficient time to make the USRPHC determination, it will be necessary to extend statutes of limitations for [redacted].

The statutes of limitations on the [redacted] Form 1065 of [redacted] will expire on [redacted]; on the Form 1065 of [redacted] on [redacted]; and the statute on [redacted]'s Form 1042 on [redacted]. To our knowledge, [redacted] did not file any Forms 8288 or 8804, the applicable forms for withholding under section 1445 and 1446, respectively. The statutes for the Forms 1120-F of [redacted] and [redacted] will expire [redacted] and [redacted], respectively. [redacted] has indicated reluctance to extend its statute.

ANALYSIS

Issues 1 and 2

On December 7, 2001, Area Counsel issued an advice on a [redacted] disposition of [redacted] stock by [redacted] which, for purposes of this advice, was identical to the [redacted] disposition. See 2000 Advice. That advice covered the legal rationale for opening TEFRA examinations on [redacted] and [redacted] in order to determine whether [redacted] was a USRPHC. There, we concluded that the determination of whether [redacted] was a USRPHC was a "partnership item," as defined under section 6231(a)(3), justifying the opening of a TEFRA examination on [redacted]. Even though [redacted] had issued a certificate stating that [redacted] was not a USRPHC at any relevant time with respect to the [redacted] disposition of [redacted] stock by [redacted], potentially relieving both [redacted] and [redacted] of any withholding requirements in connection with distributions to [redacted]'s foreign partners under section 897, we also recommended a TEFRA examination be opened on [redacted]. In accordance with the rationale of the December 2000 Advice, Area Counsel herein recommends the opening of TEFRA examinations on both [redacted] and [redacted] in connection with the [redacted] stock disposition.

There are, however, four changes in the facts for [redacted] compared to [redacted] which will affect the analysis of the [redacted] year, although not significantly. First, the taxpayer has suggested that the [redacted] stock ceased to be a U.S. real property interest when the stock began to be regularly traded after a [redacted] IPO. The taxpayer relies on section 897(c)(3) for this proposition. The taxpayer is mistaken.

Section 897(a) provides, as relevant here, that gain from the disposition of a United States real property interest shall be considered as if the gain were effectively connected with a trade or business (hereinafter "ECI") in the United

States. Section 897(c)(1)(A)(ii) provides that a United States real property interest is any interest in any domestic corporation unless the taxpayer establishes that the corporation was not a USRPHC during a relevant period. An exception to the stock being a real property interest is found in section 897(c)(3). This section provides that if any class of stock of a corporation is regularly traded on an established securities market, such stock shall be treated as a U.S. real property interest only in the case of a person who at some time during the last five year period ending on the date of the disposition of such interest held more than 5 percent of such class of stock. As [redacted] owned about [redacted] percent of the [redacted] stock prior to the [redacted] IPO, this exception to the [redacted] stock not being a real property interest in [redacted] would not be applicable in this case.

[redacted] has also suggested that, even if [redacted] is found to be a USRPHC, [redacted] has no withholding liability. As such, there would be no tax liability adjustment for [redacted]. Therefore, there is no need for a TEFRA examination at the level of [redacted] and hence no need for [redacted] to extend the statute on its Form 1065 for [redacted]. [redacted] is again mistaken.

We do not disagree that [redacted] probably has no withholding liability in connection with the sale of the [redacted] stock. Nevertheless, [redacted] is the source partnership for the determination of the section 897 ECI issue. [redacted] sold the [redacted] stock. The ECI issue is a "partnership item" of [redacted] as that term is defined in section 6231(a)(1)(3). If the tax treatment of a partnership item is at issue, the statutes require the matter be resolved at the partnership level. Maxwell v. Commissioner, 87 T.C. 783, 787 (1986). See also 2000 Advice. Moreover, there is nothing in the statute or regulations which requires that there be a potential for a tax liability of the partnership on which a TEFRA examination is opened. Rather, the issue is how the partnership treated a particular item and how that item should be adjusted as it flows through to the partners. It is normally the case that a partnership itself will have no liability.

In the instant case, the issue has to do with how [redacted] characterized the gain from the sale of the [redacted] stock for purposes of the allocation to [redacted] on its [redacted] Form 1065 and K-1's. This characterization of the gain is crucial for purposes of determining whether [redacted] has any withholding liability on the gain and whether the foreign partners have

any tax liability. If the gain is not ECI, the income is not taxable to the foreign partners and not subject to withholding. If the gain from the sale of the [redacted] stock is a U.S. real property interest because [redacted] was a USRPHC in the relevant period, then the gain is ECI. In this case, [redacted] has withholding liability under either section 1446 or section 1445, and the foreign partners of [redacted] have a tax liability under section 897.

[redacted] reported the gain as Schedule D investment gain on its [redacted] Form 1065 and reported the gain on its Schedule K-1 to [redacted] as an item on line 4e(2). As [redacted] did not believe the gain was ECI, it gave no indication of such. If the gain were ECI, [redacted] should have flagged this fact on the K-1 to [redacted] so [redacted] would know to withhold. Specifically, [redacted] should have indicated on line 25 of its Schedule K-1 to [redacted] that the gain from the [redacted] stock was ECI. See Instructions to Schedule D (Form 1065), "Items for Special Treatment."

As such, and to make adjustments at the level of [redacted] or the [redacted] partners of [redacted], the determination of whether the gain from the sale of the [redacted] stock was ECI must be made at the level of [redacted]. Also, should there be any dispute about where the withholding obligation resides, an examination must be opened on [redacted] in order to protect the Service from a whip-saw situation.

[redacted] also argues in support of its not extending its statute for [redacted] that [redacted] had no knowledge of whether [redacted] had foreign partners, and therefore [redacted] had no responsibility to make the ECI determination. Again, [redacted] is mistaken. Ignoring the fact that [redacted] was probably fully aware of the ownership of [redacted] (a fact which could be proven if necessary), [redacted]'s argument is irrelevant. The proposed TEFRA examination of [redacted] holds no liability for [redacted] or penalty for failure to make the ECI determination. [redacted] is merely the necessary location for the Service to make the ECI determination, knowing that the ultimate recipients of the gain were in fact foreign entities. The liability arising from a possible ECI adjustment will be on [redacted], a partner in [redacted]. This is the normal situation with a TEFRA examination: as discussed above, the partnership itself generally has no liability; rather it is usually the potential for a partner's tax liability which prompts the TEFRA partnership examination.

The second change of the facts between [redacted] and [redacted] is that [redacted]'s share of the distributions from [redacted] in [redacted] was [redacted], and, as in [redacted], it received no share of the gain from the disposition of the [redacted] stock. Because of the insignificant distribution to [redacted] in [redacted], in contrast to [redacted], counsel is not recommending that an examination for the [redacted] year be opened on this entity.

Third, there are additional reasons to open a TEFRA examination on [redacted] in [redacted] over [redacted] and to extend its statute. In general, opening a TEFRA audit on a source partnership and extending the statute will hold open for adjustment, as relevant here, any section 6231(a)(3) partnership item on a partner's return. Sections 6222(a), 6229 and 6231(a)(6). An adjustment on [redacted]'s return making the gain from the sale of the [redacted] stock ECI would allow the Service to adjust the item on [redacted]'s return, making such income item ECI.

But the adjustment of the gain income to ECI raises the issue of withholding obligations for [redacted] under sections 1446 or 1445. As discussed in the 2000 Advice, withholding is also a partnership item.[1] Because of this potential

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(b)(5)(AC),

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, (b)(5)(AC)

withholding tax liability, it is necessary to open a TEFRA examination on [redacted] also for [redacted].

A further reason to open a TEFRA examination on [redacted] for [redacted] is that [redacted] filed Form 1042. This form is issued in connection with any withholding on distributions to foreign entities for fixed or determinable annual or periodic income, such as dividends, under sections 1441 and 1442. [redacted] withheld in [redacted] under section 1441 in connection with approximately $[redacted] in flowthrough dividend income from an entity other than [redacted].

The examiner has indicated that the issue of correct withholding by [redacted] on its dividend income should also be examined. While the opening of a TEFRA examination on [redacted] would hold open the returns for [redacted] for the flowthrough of the $[redacted] long term capital gain from [redacted] from the sale of [redacted] stock under section 6222(a), the examination of [redacted] on the ECI issue would not hold open any items in connection with the withholding on income flowing through [redacted] from other sources. Thus, the TEFRA examination should be opened on [redacted] for this purpose. Further, the fact that [redacted] issued a Form 1042 in connection with this latter withholding has begun the running of the statute of limitations in connection with this return. In particular, this statute would run on [redacted]. Consequently, it is necessary to protect this statute with an extension also.

Next, the Service should be protected under the TEFRA procedures with respect to any required adjustments to the returns of [redacted] and [redacted] [redacted] stemming from adjustments to the returns of [redacted] and [redacted]. If [redacted] is found to be a USRPHC, the ECI adjustment will flow through to

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[redacted], (b)(5)(AC)

[redacted], (b)(5)(AC)

the [redacted] partners, regardless of whether the Service is able to establish whether [redacted] had any withholding responsibility. Nevertheless, we strongly recommend, as a precaution, that LMSB obtain Forms 872-I from [redacted] and [redacted]. This would hold open the ECI adjustment and the dividend withholding issue if extensions cannot be obtained from [redacted] and [redacted]. In all probability, the taxpayers will only be willing, if at all, to sign Forms 872-I restricted to the partnership interests in [redacted] and [redacted]. Such a restricted consent, however, would be sufficient.

Finally, as discussed in the 2000 Advice, if the gain from the disposition of the [redacted] stock is ECI, then [redacted] would have withholding responsibilities under section 1446, or alternatively under section 1445. The withholding forms to be filed under these particular sections are Forms 8804 and 8288, respectively. As [redacted] neither withheld under these sections nor filed either of these forms in [redacted], no statute of limitations is currently running on these returns. Section 6501(a). Hence, there is no need to protect any statutes for this withholding. We recommend, however, that LMSB examination issue Forms 872 in connection with the withholding liabilities under section 1445 and 1446 as a precaution.

Thus, based on the above, we recommend opening TEFRA

examination on both [redacted] and [redacted] and securing the following statute extensions:

Entity	Statute to Protect	Extension Form
[redacted]	1065	872-P
[redacted]	1065	872-P
	1042	872
	8804	872
	8288	872
[redacted]	1120-F	872-I
[redacted]	1120-F	872-I

The statute extensions for [redacted] and [redacted] are precautionary. If necessary, these extensions could be limited to cover the partnership interests in [redacted] and [redacted]. Please coordinate with Area Counsel on the language of the extensions.

Issues 3 and 4

Law

Section 897(a) provides, as relevant here, that gain of a nonresident alien individual or corporation from the disposition of a United States real property interest shall be taken into account as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain were effectively connected with such trade or business.

Section 897(c)(1) provides that the term "United States real property interest" means (ii) any interest in any domestic corporation unless the taxpayer establishes (at such time and in such manner as the Secretary by regulations prescribes) that such corporation was at no time a United States real property holding corporation during the 5-year period ending on the date of the disposition of such interest or the period in which the taxpayer held the interest, whichever is shorter. A USRPHC is any corporation if its holdings equal or exceed 50 percent of the value of the all real property interests and the value of its assets used in a trade or business. As discussed under Issues 1 and 2, the exception for stock of a U.S. corporation not being a U.S. real property interest is not applicable in the instant case.

As provided for in section 897(c)(1)(A)(ii), Treas. Reg.

§ 1.897-2(g)(1) lays out the method for the taxpayer to establish that a corporation is not a USRPHC. This regulation provides that foreign persons disposing of an interest in a domestic corporation must establish that the interest was not a U.S. real property interest as of the date of the disposition, either by: (A) obtaining a statement from the corporation or (B) obtaining a determination by the Director, Foreign Operations. This regulation goes on to say that if the foreign person does not establish by either method that the interest disposed of was not a U.S. real property interest, then the interest shall be presumed to have been a U.S. real property interest, the disposition of which is subject to section 897(a).

It should be noted, however, that the method described in the regulation to establish that a corporation is not a USRPHC applies only for purposes of excusing a withholding agent from the withholding tax under sections 1445 and 1446. It does not excuse the taxpayer from its liability under section 897 if the Service later determines that the corporation was a USRPHC.

Analysis

The Service is currently in the process of valuing [redacted] to make the determination whether it was a USRPHC at the time of the [redacted] stock disposition by [redacted]. This valuation cannot be completed prior to the expiration of the relevant statutes in this case. [redacted], the source partnership in this case, has indicated a reluctance to extend the statute for its Form 1065. In the event of such refusal, the Service can issue FPAAs to [redacted] and [redacted] based on the presumption that the [redacted] stock was a U.S. real property interest. The FPAA would not be arbitrary.

Ordinarily, the Commissioner's determination of tax liability is presumed correct. Welch v. Helvering, 290 U.S. 111, 115 (1933); Tax Court Rules of Practice and Procedure 142(a). The taxpayer, therefore, bears the burden of proving the determination erroneous or arbitrary. Welch, 290 U.S. at 115; Webb v. Commissioner, 872 F.2d 380, 381 (11th Cir.1989). As the language of the regulations, which regulations are legislative regulations, unambiguously provides for such a presumption that a corporation is a USRPHC in the absence of any substantiation to the contrary, the issuance of an FPAA to [redacted] and [redacted] based on the presumption where there has not

been the required substantiation is not arbitrary.

Section 897(c)(1)(A) requires taxpayer substantiation that a corporation was not a USRPHC for the relevant period in order for an interest in such corporation to not be a U.S. real property interest, the disposition of which results in ECI. This statute provides for regulations to spell out what is required, giving the regulations particular force as legislative regulations. Legislative regulations are entitled to "controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." Schuler Industries, Inc. v. United States, 109 F.3d 753, 755 (Fed. Cir. 1997) (citing Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 844, (1984)).

Treas. Reg. § 1.897-2(g)(1) provides for two methods of substantiation, a statement from the corporation stating that it was not a USRPHC during the relevant period or obtaining a determination by the Director, Foreign Operations. None of the taxpayers involved in this case substantiated the fact that [redacted] was not a USRPHC in connection with the [redacted] sale of [redacted] stock by [redacted]. Hence, reliance on the presumption would not be arbitrary.

Because of the presumption that the interest in [redacted] was a U.S. real property interest and the failure of [redacted] or [redacted] to substantiate otherwise, the Service could and should issue FPAAs to both [redacted] and [redacted] if either one refuses to extend their respective statutes. The issuance of an FPAA to either entity would trigger the need to issue one to the other. As discussed above, an FPAA to [redacted] for the ECI and withholding adjustments would not be in compliance with the statutory TEFRA scheme without the ECI adjustment on [redacted].

Similarly, an FPAA to [redacted] on the ECI issue without simultaneously issuing an FPAA to [redacted] adjusting the ECI and imposing withholding tax liability would be futile as no withholding liability would result. Splitting the actions for the determination of ECI and withholding would be administratively and judicially inefficient. Further, issuing only an FPAA to [redacted] on the ECI issue would enable [redacted] could go to district court or the Claims Court without depositing the withholding liability. Sections 6226(a), 6226(e).

The FPAAs, if issued, should contain the following adjustments. The FPAA to [redacted] should state as an adjustment

that the income from the sale of the [redacted] stock in [redacted] was ECI income, and should be reported accordingly on the Form 1065 and K-1 to [redacted]. The FPAA to [redacted] should have two separate adjustments: one setting forth a determination of ECI and the second determining the amount of the withholding tax liability as [redacted] was the withholding agent on the distributions of the $[redacted] to [redacted] and [redacted] under section 1446, or alternatively, under section 1445. Sections 897(a)(1), 1446, 1445. As discussed in the 2000 Advice, section 1446 is the preferred withholding provision for the transaction at issue. If such a notice is issued, we recommend that the notice also include as an alternative section, the withholding required under section 1445.

Please consult with Area Counsel in connection with the correct language for the FPAAs.

Issue 5

Law

Section 897(c)(2) provides that a USRPHC means any corporation if--

> (A) the fair market value of its United States real property interests equals or exceeds 50 percent of
> (B) the fair market value of (i) its United States real property interests, (ii) its interest in real property located outside the United States, plus (iii) any other of its assets which are used or held for use in a trade or business.

Treas. Reg. § 1.897-1(f)(1) provides three categories of assets which are assets used or held for use in a trade or business for purposes of measuring whether an entity is a USRPHC. These are: (i) property, other than a U.S. real property interest, that is (A) stock in trade or other property which would be included in the inventory or held for sale to customers in the ordinary course of its trade or business, or (B) depreciable property used or held for use in the trade or business, or (C) livestock used or held for use in a trade or business, (ii) goodwill and going concern value, patents, inventions, formulas, copyrights, literary, musical

or artistic compositions, trademarks, trade names, franchises, licenses, customer lists and similar intangible property, but only to the extent that such property is used or held for use in the entity's trade or business and subject to the valuation rules of Treas. Reg. 1.897-1(o)(4), and (iii) cash, stock, securities, receivables of all kinds, options or contracts to acquire any of the foregoing, and options or contracts to acquire commodities, but only to the extent that such assets are used or held for use in the corporation's trade or business and do not constitute U.S. real property interests.

Treas. Reg. § 1.897-1(f)(2) further provides that an asset is used or held for use in an entity's trade or business if it is, (i) held for the principal purpose of promoting the present conduct of the trade or business, as, for example, in the case of stock acquired and held to assure a constant source of supply for the trade or business, (ii) acquired and held in the ordinary course of the trade or business, as, for example, in the case of an account or note receivable arising from that trade or business (including the performance of services), or (iii) otherwise held in a direct relationship to the trade or business.

The flush language of this regulation states that in determining whether an asset is "held in a direct relationship to the trade or business," consideration shall be given to whether the asset is needed in that trade or business. An asset shall be considered to be needed in a trade or business only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset shall be considered as needed in the trade or business if, for example, the asset is held to meet the operating expenses of that trade or business. Conversely, an asset shall be considered as not needed in the trade or business if, for example, the asset is held for the purpose of providing for future diversification into a new trade or business, future expansion of trade or business activities, future plant replacement, or future business contingencies.

Analysis

In applying the formula of section 897(c)(2) to measure whether [redacted] is a USRPHC, [redacted] has included a value for its NOLs in the denominator under the category of section 897(c)(2)(B)(iii)'s "any other of its assets which are used or held for use in a trade or business." (This category of the

formula is hereinafter referred to as "business enterprise value" or "BEV.") [redacted] argues that the NOLs should be included in the BEV portion of the denominator under the following rationale. If the value of two identical businesses were compared, one located in a low tax area and the other in a high tax area, by normal business valuation standards, the former would be more valuable. While this observation is true, it is not the standard contemplated in the statute and regulations in order to measure whether a corporation was a USRPHC at a particular point in time. [redacted]'s inclusion of NOLs in BEV is contrary to both the letter and spirit of the statute and regulations. As such, no value for the NOLs should be so included in the denominator of the computation for determining whether [redacted] was a USRPHC in [redacted].

The regulations under section 897(c)(2) are written to insure that in determining whether a corporation is a USRPHC, the denominator of the critical ratio cannot be inflated by assets not integral to the trade or business of the corporation. In general, all of the assets specifically included in the BEV by the regulations are of a sort actively used in a trade or business. The trade or business of [redacted] is that of operating [redacted] and real estate development. The only contribution the NOLs make to this business is the reduction of future taxes. This sort of contribution was not what was envisioned by the statute and regulations for an asset in BEV.

More specifically, NOLs do not fit into any of the categories of assets which the regulations specifically include in BEV. First they are not property, which includes such things as inventory or property held for sale to customers in the ordinary course of business, depreciable property and livestock. Second, NOL's do not fit into the category of assets which includes goodwill and going concern value, patents, inventions, trademarks, licenses, and similar intangible property. The NOLs cannot be considered "similar intangible property" here. The common characteristic of all of the mentioned intangible assets is their positive contribution to the nature and operation of the business and its earning power. The NOLs, in contrast, make purely a negative or passive contribution; they reduce future taxes.

Nor do NOLs fit into the regulation's final asset category of liquid assets, which includes cash, stock, securities, receivables, options or contracts to acquire any

of the foregoing, or contracts to acquire commodities but only to their extent these assets are used in the business. The conclusion that NOLs do not fit into this category is based on the definition of assets "used or held for use in a trade or business" in the regulations. The assets included are those held for the principal purpose of promoting the present conduct of the business, such as stock to assure a constant supply; assets acquired and held in the ordinary course of business, such as a note receivable arising from that business; or otherwise held in a direct relationship to the business. Clearly, the NOL does not fit into the first two categories.

Nor does the NOL have a direct relationship with the business of [redacted]. In order to determine whether an asset is held in direct relationship to the trade or business, it must be determined whether the asset is needed in the business. To be needed, the asset must be held to meet the present needs of that business, not for anticipated future needs. The regulations give an example of a needed asset as one held to meet the operating expenses of that business. In this regard, see Treas. Reg. § 1.897-1(f)(4), Example 1, where the holding of a large cash balance was only a BEV asset because the cash balance was necessary to meet the purchasing and payroll needs of the business, and was so managed.

Although the reduction in tax from the NOLs contributes to available cash, the NOL is certainly not held to meet operating expenses of [redacted]. Rather, it is a holdover from prior year's losses and does not contribute to the current operation of the business in any manner other than serve to lower taxes. While this does leave more cash for the operation of the business or for future investments, assets held for the purpose of future needs are specifically mentioned as not included in the business value for purposes of the section 897(c)(2 formula. Thus, by the terms of the regulations, the NOL has no direct relationship with the business of [redacted], and its value should not be included in the BEV.

Finally, even if the NOL were considered to fall in the category of Treas. Reg. § 1.897-1(f)(1)(iii), cash, stock, securities, (and we do not believe this is the case), such an asset can only be presumed to be used for the trade or business in an amount up to 5 percent of the fair market value of other assets used or held for use. Treas. Reg. § 1.897-

1(f)(3)(i). The value [redacted] would place on the NOLs far exceeds this amount.

Issue 6

Law

Section 897(a) provides, as relevant here, that gain of a nonresident alien individual from the disposition of a United States real property interest shall be taken into account as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain were effectively connected with such trade or business.

Section 897(c)(1)(A) provides that the term "United States real property interest" means, as relevant here, (ii) any interest in any domestic corporation unless the taxpayer establishes (at such time and in such manner as the Secretary by regulations prescribes) that such corporation was at no time a United States real property holding corporation during the 5-year period ending on the date of the disposition of such interest or the period in which the interest was held by the taxpayer, whichever is shorter.

Section 897(c)(b)(B) provides that the term, "United States real property interest" does not include any interest in a corporation if--(i) as of the date of the disposition of such interest, such corporation did not hold any United States real property interests, and (ii) all of the United States real property interests held by such corporation at any time during the shorter of the period described in the above paragraph under (ii) above (I) were disposed of in transactions in which the full amount of the gain (if any) was recognized, or (II) ceased to be United States real property interests by reason of the application of this subparagraph to one or more other corporations.

Treas. Reg. § 1.897-2(b) provides that if a corporation qualifies as a USRPHC on any applicable determination date after June 18, 1980, any interest in it shall be treated as a U.S. real property interest for a period of five years from that date, unless the provisions of paragraph (f)(2) are applicable.

Treas. Reg. § 1.897-2(f)(2) provides for early

termination of interests in a USRPHC being U.S. real property interests if the following conditions are met: the corporation does not hold any U.S. real property interests, and all of the U.S. real property interests directly or indirectly held by such corporation at any time during the previous five years (A) were directly or indirectly disposed of in transactions in which the full amount of the gain, if any, was recognized, or (B) ceased to be U.S. real property interests by reason of the application of paragraph (f) to one or more other corporations.

Tres. Reg. § 1.897-2(f)(1) provides that a USRPHC may voluntarily determine its status as of the date of any acquisition or disposition of assets. If the fair market value of its U.S. real property interests on such date no longer equals or exceeds 50 percent of the fair market value of its U.S. real property interests, interests in real property located outside the United States and assets used or held for use in a trade or business held directly by the corporation, then such corporation shall cease to be a USRPHC as of such date, and on the date that is five years after such date interests in such corporation shall cease to be treated as U.S. real property interests.

Analysis

A Service determination that [redacted] was a USRPHC at some point in [redacted] cannot be rendered null with respect to the disposition of the [redacted] stock on [redacted], by a taxpayer showing that at a date closer to the disposition, [redacted] was not a USRPHC. Ordinarily, in order for an interest in stock of any domestic corporation to not be a United States real property interest, the corporation cannot have been a USRPHC during the five year period ending on the date of the disposition of such interest or the period in which the interest was held by the taxpayer, whichever is shorter. In the instant case, [redacted] had held the [redacted] stock for more than five years at the date of the [redacted] disposition.

Consequently, this means that, except for the possibility of early termination under Treas. Reg. § 1.897-2(f)(2), if [redacted] were a USRPHC at any time between [redacted], and the [redacted], disposition of the [redacted] stock by [redacted], the disposition would have been of a U.S. real property interest, and the gain from the disposition ECI. [redacted] did not meet the early termination provisions of Treas. Reg. § 1.897-2(f)(2). Thus,

the earliest date on which a measurement subsequent to [redacted] showing that [redacted] was not a USRPHC could change the fact of the stock in [redacted] being a U.S. real property interest would be on the date five years after such measurement date. Treas. Reg. 1.897-2(f)(1). This date would necessarily be after the [redacted], disposition at issue.

If you have any questions on this matter, please do not hesitate to contact us.

DAVID J. MUNGO
Associate Area Counsel

(LMSB)

By: _____
VIRGINIA L. HAMILTON
Attorney (LMSB)

Attachment:
As stated

cc: Mary Kay Lee Martinez, International Field Counsel
Janet Balboni, TEFRA Counsel
Mac Marriott, Team Coordinator
Dorothy Alden, LMSB Agent
Kerry Packard, Engineer

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:DEN:TL-N-3604-00
VLHamilton

date: 07 DEC 2000

to: LMSB Examination
Attn: [redacted]

from: Acting Associate Area Counsel (LMSB)

subject: [redacted] -- Recommendations on Opening TEFRA Examination

This memorandum responds to your request for Associate Area Counsel Advice (LMSB) regarding the following issues.

ISSUES

1. Is the determination of whether TEFRA partnerships had effectively connected income a partnership item under section 6231, requiring the determination to be made at the partnership level.

2. Is the determination of whether the partnerships receiving effectively connected income were required to withhold under section 1446 a partnership item under section 6231, requiring the determination to be made at the partnership level.

3. If the determinations should be made at the partnership level, on which partnership(s) should TEFRA examinations be opened.

4. Which return governs the statute of limitations in this case, the Form 1065 or the Form 8804.

CONCLUSIONS

1. The determination of whether TEFRA partnerships had effectively connected income is a partnership item under section 6231, requiring the determination to be made at the partnership level.

2. The determination of whether the partnerships receiving effectively connected income were required to withhold under section 1446 is a partnership item under section 6231, requiring the termination to be made at the partnership level.

3. A TEFRA proceeding should be opened on all three

partners for the [redacted] year: [redacted] Partners, [redacted] and [redacted] (the latter if you believe the distributions from [redacted] Inc. from its sale of property exceeded the partner's basis in [redacted], Inc.)

4. The Form 1065 controls the statute of limitations.

FACTS

[redacted], Inc. (hereinafter "[redacted]") was closely held by [redacted] groups prior to an IPO on [redacted]. On that date, [redacted] sold [redacted] shares of common stock. [redacted] Partners, a U.S. partnership (hereinafter "[redacted]"), held the largest interest prior to the IPO, approximately [redacted] percent. [redacted] was and is owned by two U.S. partnerships: [redacted] (herein after "[redacted]"), and [redacted]. [redacted] owns approximately [redacted] percent of [redacted] and [redacted] owns [redacted] percent. The partners in [redacted] are two [redacted] corporations. [redacted]'s partners include primarily [redacted] and other foreign entities and persons, but some interests are also held by U.S. entities.

[redacted] distributed a right to receive up to $[redacted] per share of common stock to all stockholders of records of [redacted], with the maximum payable of $[redacted]. [redacted] was obligated to make such payments only to the extent it received sufficient gross proceeds upon the closing of certain real estate contracts. [redacted] made the full payment under the rights in [redacted], probably in the third quarter. We estimate that [redacted] received approximately $[redacted] in this distribution, treated by all parties as a return of capital. [redacted] had no current earnings or prior E&P.

Also on [redacted], the date of [redacted]'s IPO, [redacted] sold additional shares of [redacted]. [redacted] is reported to have received a $[redacted] in this sale. On its [redacted] Form 1965, [redacted] reported a gain of $[redacted], all of which was allocated to [redacted]. In [redacted], [redacted] distributed a total of $[redacted] to its two partners.

On [redacted], [redacted] issued a notice pursuant to Treasury Regulation § 1.897-2(h)(2), indicating that [redacted] had determined that it was not a U.S. real property holding corporation and was not one at any time during the period in which [redacted] owned stock issued by [redacted]. Upon a preliminary review of the work papers upon which this statement is based, the large case examiner believes that [redacted]'s determination that it was not a USRPHC was in error and that the Service should have an in-house engineer appraise the value of [redacted]'s assets to determine whether in fact [redacted] was a USRPHC in early [redacted].

Because [redacted] has partnerships as partners, and these

partnerships have foreign partners, all partnerships at issue are TEFRA partnerships. None of the indirect foreign partners of [redacted] reported any gain from the transactions described above in [redacted]. Nor did [redacted], [redacted] or [redacted] withhold any amounts from the distributions to the foreign partners as a result of the transactions.

ANALYSIS

Law

I.R.C. § 6221 provides that, except as otherwise provided, the tax treatment of any partnership item shall be determined at the partnership level. Section 6231(a)(1) defines the term "partnership" to mean, for purposes of the instant case, a partnership in which one of the partners is other than an individual or is a nonresident alien. Section 6231(a)(2) defines the term "partner" to mean a partner in the partnership and any other person whose income tax liability under subtitle A is determined, in whole or in part, by taking into account, directly or indirectly, partnership items of the partnership.

Section 6231(a)(3) defines the term "partnership item" as any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of subtitle F, such item is more appropriately determined at the partnership level than at the partner level. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(i) further defines "partnership item." As relevant here, this regulation specifies that the partnership aggregate and each partner's share of items of income, gain, loss, deduction, or credit of the partnership, items which are required to be taken into account for the taxable year of a partnership under subtitle A of the Code, are more appropriately determined at the partnership level than at the partner level and are therefore "partnership items." Treas. Reg. § 301.6231(a)(3)-1(b) provides that the term "partnership item" also includes the legal and factual determinations that underlie the determination of the amount, timing and characterization of items of, as relevant here, gain.

Under section 861(a)(5), gain from the disposition of a United States real property interest, as defined in section 897(c), is an item of gross income treated as income from sources within the United States. Section 897(a) provides that, as relevant here, gain of a nonresident alien or a foreign corporation from the disposition of a United States real property interest shall be taken into account as if the foreign taxpayer were engaged in a trade or business within the United States and

as if such gain or loss were effectively connected with such trade or business.

Section 897(c)(1)(A) defines a United States real property interest, for purposes herein, as an interest in real property and any interest in any domestic corporation unless the taxpayer establishes that such corporation was at no time a United States real property holding corporation, as relevant here, during the period during which the taxpayer held such interest.

Section 897(c)(2) defines a USRPHC as any corporation if the fair market value of its United States real property interests equals or exceeds 50 percent of the fair market value of its U.S. real property interests, its interests in real property located outside the U.S. plus any other of its assets which are used or held for use in a trade or business. Treas. Reg. § 1.897-1(e)(1)(ii) provides that for purposes of determining when a foreign person has a reporting obligation, the holder of an interest in a partnership is treated as owning a proportionate share of the U.S. real property interests held by the partnership. Section 6039C, dealing with the reporting requirements of foreign persons holding direct investments in U.S. real property interests, provides, as relevant here, that real property interests held by a partnership are treated as owned proportionately by its partners. Section 6039C(3)(A). Section 63 defines taxable income as gross income minus allowable deductions.

Section 1446 requires that if a partnership has effectively connected taxable income for any taxable year and any portion of such income is allocable under section 704 to a foreign partner, such partnership shall pay a withholding tax under this section. Section 1446(c) defines effectively connected taxable income as taxable income of the partnership which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

Sections 301(a) and (c) provide that a distribution of money made by a corporation to a shareholder with respect to its stock shall be treated as a dividend to the extent of the earnings and profits of the corporation, as a reduction of basis for that portion not a dividend, and for any distribution in excess of the adjusted basis of the stock, as a gain from the sale or exchange of property.

Issue 1.

If [redacted] is found to have been a USRPHC at the time of the [redacted] IPO, [redacted] would have effectively connected income.

In particular, the gain on the sale of the [redacted] stock sold by [redacted] on [redacted], would be effectively connected taxable income subject to U.S. federal income tax by [redacted]'s indirect partners, that is, the foreign partners of [redacted]. Sections 897(a); 897(c)(1); 897(c)(2); 63; 1446(a) and 1446(c). It was to this partnership and hence its partners that all of [redacted]'s gain from the sale of the [redacted] stock was allocated. Such income would be taxable ultimately to [redacted]'s indirect partners, the foreign partners of [redacted]. Treas. Reg. § 1.897-1(e)(1)(ii). Further, if any of the distribution made by [redacted] in [redacted] from the sale of property made in connection with the [redacted] rights offering exceeded [redacted]'s basis in [redacted], it too would be effectively connected taxable income subject to tax by the foreign partners of [redacted] and [redacted]. Sections 897(a); 897(c)(1); 63; 301(a); 301(c)(3); 1446(a)(1446(c).

In order to determine whether [redacted] has effectively connected income, it is necessary to know whether [redacted] was a USRPHC in early [redacted]. To make this determination, the Service should open TEFRA partnership proceedings on [redacted] because effectively connected income is a partnership item requiring a determination of such at the partnership level.

Congress enacted the TEFRA unified partnership audit provisions to provide a method for uniformly adjusting items of partnership income, loss, deduction or credit rather than to continue the procedures existing prior to 1982 under which each partner's liability was determined independently. Under the TEFRA provisions, "if the tax treatment of a 'partnership item' is at issue, the statute requires the matter to be resolved at the partnership level." Maxwell v. Commissioner, 87 T.C. 783, 787 (1986). Consequently, one proceeding determines all of the partnership items with respect to a partnership. Roberts v. Commissioner, 94 T.C. 853 (1990).

In accordance with section 6221, the tax treatment of any partnership item is determined at the partnership level unless specifically provided otherwise in the unified partnership audit provisions of sections 6221 through 6233. Section 6231 defines "partnership item" as any item required to be taken into account for the partnership's taxable year under any provisions of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of subtitle F, such item is more appropriately determined at the partnership level than at the partner level. Treas. Reg. § 301.6231(a)(3)-1(a), a regulation under subtitle F, provides that the partnership aggregate and each partner's share of items of income, gains, loss, deduction or credit are partnership items more appropriately dealt with at the partnership level.

While the TEFRA partnership regulations do not specifically define "effectively connected taxable income" as a partnership item, it clearly falls within the definition of a partnership item as set forth in Treas. Reg. § 301.6231(a)(3)-1(a). In addition, the legal and factual determinations that underlie the determination of the amount, timing and characterization of effectively connected taxable income constitute partnership items within the meaning of Treas. Reg. § 301.6231(a)(3)-1(b).

Furthermore, in the instant case, there will be actual adjustments on the partnership return, which adjustments will affect the way the partners should treat the distributions for tax purposes. In particular, [redacted] reported the gain on the sale of the [redacted] stock as Schedule D investment gain, similarly reporting it on the Schedule K-1's as an item of line 4. Should [redacted] be a USRPHC, the gain from this sale would be income effectively connected with a trade or business in the United States, and hence [redacted] should have reported this gain on the Schedule 1065, line 6 or 7. Section 897(a)(1). Although we do not have the [redacted] return of [redacted], we suspect that [redacted] treated the gain from the sale of the [redacted] stock in accordance with [redacted]'s treatment. Thus, adjustments would also need to be made here on the partnership return. With respect to the possibility of the dividends from [redacted] exceeding the bases of [redacted] in its [redacted] stock, this would similarly require an adjustment on [redacted]'s returns as well as those of [redacted] and [redacted] to show gain. [redacted] did not show any of the distributions from [redacted] as income on its [redacted] Form 1065, and such treatment was followed by the upper tier partnerships.

Thus, the determination of the partnership's amount of effectively connected taxable income is a determination of the amount of gain [redacted] and [redacted] received. This determination is more appropriately made at the partnership level. Consequently, TEFRA partnership proceedings apply to the determination with respect to effectively connected income, and a TEFRA examination should be opened.

Issue 2

Further, if the examiner determines that [redacted] was in fact a USRPHC in early [redacted], then one or more of [redacted], [redacted] and [redacted] may have been required to withhold on the distributions to foreign partners under section 1446.[1] This determination also

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[1] Counsel will supplement this memorandum with a final analysis supporting the application of section 1446 withholding obligations to the facts at issue. Although section 1445 was

specifically designed to govern withholding on dispositions of U.S. real property interests, we preliminarily conclude that section 1446 is the applicable statute under the facts of this case because of complications with the language of section 1445. This position has been discussed with the National Office. Specifically, section 1445(e) provides that the partnership which disposes of U.S. real property interests is liable for the withholding. This provision by its explicit terms would only apply in this case to withholding by [redacted]. But currently, there is no withholding obligation of [redacted] under section 1445. Treas. Reg. § 1.1445-5(b)(8)(vi) provides that in the case of tiered partnerships, no withholding is required upon the disposition of a U.S. real property interest by a partnership which is directly owned, in whole or in part, by another domestic partnership until the effective date of a Treasury Decision published under section 1445(e) providing rules governing this matter. Further, no other provision of section 1445 or its regulations explicitly applies to the upper tier partnerships, [redacted] and [redacted], the partnerships having the direct foreign partners.

The withholding provisions of section 1446, however, can be applied to the transactions at issue. See Rev. Proc. 89-31, 1989-1 C.B. 895 (Withholding: Partnership income: Foreign partners). This revenue ruling at Sec. 7., 02, 2 anticipates that there may be overlap between the provisions of section 1446 and section 1445, and so provides that the withholding requirements shall not be duplicative. The applicability of section 1446 to a U.S. real property interest transaction is further bolstered by the 1988 amendments to section 1446. Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, § 1012(s)(1)(A), 102 Stat. 3342, 3526 (hereinafter the "Act"). Prior to 1988, section 1446(c), providing for exceptions to withholding under 1446, specifically provided in section 1446(c)(3) for the exclusion from withholding under section 1446 for those amounts withheld under section 1445. This provision arguably could have meant that section 1446 was not intended to apply to U.S. real property interest transactions. But the Act removed section 1446(c). This removal eliminated the possible argument that section 1446 was not meant to apply to U.S. real property transactions.

[redacted]

involves a "partnership item," justifying a TEFRA examination.

The Internal Revenue Code ensures the payment of taxes due to the United States from nonresident aliens, foreign partnerships and foreign corporations by requiring domestic payors to withhold taxes. Sections 1441 through 1464. For the year at issue, section 1446 requires a partnership to pay withholding tax if the partnership has effectively connected taxable income and any portion of the income is allocable to a foreign partner pursuant to section 704. The partnership must file an annual return, Form 8804, Annual Return for partnership Withholding Tax, to report the total amount of withholding tax on income of foreign partners. Section 1461 imposes liability for the tax directly on any partnership required to deduct and withhold. Partnerships which fail to comply may be subject to civil and criminal penalties.

The determination of the partnership's liability for withholding tax pursuant to section 1446 requires a determination of the effectively connected taxable income of the partnership. As discussed above, the adjustments to effectively connected taxable income in section 1446(c) are partnership items as defined in Treas. Reg. §§ 301.6231(a)(3)-1(a)(1) and -1(b). Section 1446(c) essentially defines effectively connected taxable income as the partnership's taxable income, as computed under Subchapter K, with the following adjustment, as relevant here: partnership items that are normally stated separately are included if they generate effectively connected income. Section 1446(c); Rev. Proc. 89-31, 1989-1 C.B. 895, Sec. 6.

Further, the determination of the partnerships' liabilities under section 1446 is also a TEFRA item. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(v) provides that the partnership's aggregate of partnership liabilities is a partnership item. Moreover, the legislative history of section 1446 reflects that Congress considered the section 1446 withholding tax to be a partnership item. In describing the 1988 amendments to section 1446, the House Committee Report states that "this withholding tax is a partnership level-computation." H.R. Rept. No. 795, 100th Cong., 2d Sess. 291 (1988).

As the section 1446 liability is directly imposed on the partnership and the determinations with respect to effectively connected taxable income are more appropriately made at the partnership level, TEFRA partnership proceedings apply to

[redacted].

determinations with respect to section 1446.[2]

Whether there is in fact a withholding requirement on any of the partnerships, however, will depend on, first, whether [redacted] or [redacted] knew or had reason to know that [redacted]'s statement regarding its USRPHC status was incorrect. Treas. Reg. § 1.1445-5(b)(3)(iii)(B). In such case, the partnership(s) would not have been entitled to rely on the [redacted] statement and are liable for the withholding and all applicable penalties. With respect to the foreign partners of [redacted] and [redacted], even if they relied in good faith upon the statement, they are not excused from filing a return and paying any taxes and interest due thereon if the statement regarding [redacted]'s USRPHC status is found to be correct. Treas. Reg. 1.897-2(g)(1)(ii)(A).

Additionally, if [redacted] were a USRPHC, there would be further adjustments in that the partnerships would have had to file Form 8804 reporting their withholding tax liabilities. For purposes of the withholding tax liabilities, at least [redacted] is a nonfiler, and perhaps also [redacted] and [redacted]. The adjustment with respect to the effectively connected taxable income with respect to the Form 8804 liability is [redacted] percent of the amount found to be such type of income.

Issue 3

Neither [redacted] nor the two upper tier partnerships with foreign partners, [redacted] and [redacted], characterized any income on their Forms 1065 as effectively connected taxable income, nor withheld any amounts in connection with the potential [redacted] U.S. real property transactions or the [redacted] related transactions. In this situation, given the facts as we know them, a TEFRA proceeding should be opened on all three partners for the [redacted] year: [redacted], [redacted] and [redacted] (the latter if you believe the distributions from [redacted] from its sale of property exceeded [redacted]'s basis in [redacted]). The audit of [redacted] Partners would be to determine whether there is any effectively connected income, a partnership item, that passes to the partners. While this proceeding would hold the statute of limitations open for all of the direct and indirect partners of [redacted] with respect to the issue of effectively

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[redacted]

connected income, there must also be proceedings opened on [redacted] and [redacted]. These proceedings are necessary to determine whether, if there is effectively connected income stemming from [redacted], [redacted] and [redacted] have any liability under sections 1445 and 1446.

Sections 1445 and 1446 impose a liability under subtitle A on partnerships with foreign partners. For these purposes, the partnership itself is treated as a partner under section 6231(a)(2) since, contrary to the normal situation, the Service will actually be assessing and collecting a tax against the partnership as an entity. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(v) makes the liabilities of a partnership, which it is required to take into account under subtitle A, partnership items. As discussed above, partnership items must be determined through a TEFRA proceeding. As both [redacted] and [redacted] potentially have liability under section 1445 or 1446, such liabilities can only be determined in a TEFRA proceeding against [redacted] and [redacted], the partnerships that incurred such liability. Thus, the partnerships should be sent notices of the TEFRA proceedings as if they are partners in themselves.

To our knowledge, none of the foreign partners have filed any income tax returns for [redacted], so there is no limitation problem with them in any event.

Issue 4

All of the U.S. partnerships filed Form 1065's for the [redacted] tax year. None of them filed any Forms 8804. Unless the Service is able to prove under the regulations of section 897 that [redacted] did not in good faith rely on the [redacted], statement of [redacted] that it was not a USRPHC during the relevant periods, neither it nor either of the upper tier partnerships would be required to file Form 8804. Hence, for purposes of the TEFRA examination to determine whether any of the income at issue was effectively connected with a U.S. trade or business, the return for control is the Form 1065.

If you have any questions on this matter, please do not hesitate to contact us.

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